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New paradigms imposed by the global financial crisis

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Abstract. *The global financial crisis that erupted in 2008 was a welter of complex phenomena, some of them unprecedented. The amplitude of the crisis and its impact on the real economy caused major unprecedented problems in public finance. Therefore, the confidence in government`s ability of management and financing was weakened, especially in the European countries. The paper analyzes several paradigm shifts imposed by the negative effects of the crisis felt both in the financial system and in the real economy.*

Keywords: financial system, financial crisis, paradigm, theory of efficient markets, deregulation.

JEL Classification: B00, E00, G01.

Introduction

Over time, the occurrence of anomalies in the economic area, financial and economic crisis respectively, has led to the emergence of new paradigms or new ways to analyze and perceive various economic phenomena. Any paradigm identifies the nature of the new arising problems, formulates economic policy objectives and establishes suitable instruments for achieving them (Hall, 1993).

The economic and financial crisis of 2008 is the first global crisis that occurred after the Great Depression of the '29 –'33. This is probably the most complex crisis of all times, not necessarily in terms of its effects, but in terms of the causes that had generated it. The complexity of its causes resides in the fact that the turbulences were caused by two types of factors that have complemented each other: factors that had been causes of financial crises in the past, such as the emergence of speculative bubbles, expansion of credit, indebtedness or inadequate regulation and supervision, and new elements and developments, such as the emergence of complex financial products, characterized by a high degree of opacity, excessive exposure to the risk of most players in the financial market, the unprecedented growth of interdependences between financial markets and institutions both nationally and internationally or the widespread use of risky debt-investment schemes (Moldovan and Popa, 2012).

The origins of the crisis are to be found in the subprime mortgage market of the United States. Problems then extended across the entire US financial system, along with worldwide contamination of financial markets. The financial crisis has triggered recessions in many economies of the world, and later, the complexity of financial and economic phenomena has triggered a sovereign debt crisis, especially in European countries.

The crisis has highlighted the fact that the regulation and supervision of financial markets had failed to keep pace with the needs imposed by their rapid and unprecedented development. Therefore, several deficiencies arose regarding proper assessment of risks incurred by financial institutions, the soundness of financial institutions and management of systemically important financial institutions.

From the ideological point of view, the crisis has triggered a heated debate on the ability of self-regulation of markets and state intervention opportunity, and even put into question the soundness of the capitalist system.

Furthermore, the complexity of the problems imposed by the crisis in public finance has caused discussions on state intervention under such circumstances, and undermined confidence in government's ability to properly manage the budget deficit and public debt issues.

Paradigms of the past

One of the most persistent economic paradigm is the one induced by the *efficient markets hypothesis*, according to which, within in the market, competing interests of economic agents interact in such a way that the result is a balanced and efficient system. As Adam Smith argued, an "invisible hand" intervenes and regulates markets so that they tend towards equilibrium**.**

Scholars have developed this theory and have issued another hypothesis, which says that since markets are self-regulating, asset prices are fair and justified, precisely encompassing all information relating thereto (Bachelier, 1900). This hypothesis basically refutes the emergence of overvalued financial assets, as the value of an asset is always correctly assessed by rational economic agents, based on existing information, and the change of an asset`s price is always determined by the emergence of new information regarding the asset.

These ideas have been embraced with enthusiasm by the economists at the University of Chicago, who have been the devotees of market fundamentalism or "laissez-faire" policies and who have argued that markets are, by their nature, rational, efficient and able to regulate themself (Roubini and Mihm, 2010). Beyond these issues, efficient markets hypothesis has referred to the fact that financial markets always allocate available funds to the most profitable investment projects, thus helping to maximize welfare. Moreover, it has even been argued that financial markets have the ability to regulate themselves and the authorities should not have interventions in financial markets (Greenspan, 2007).

Despite the fact that the efficient market hypothesis has become widely accepted and many governments have implemented ultra-liberal policies, studies have shown that it is not sustainable. For example, Robert Shiller has demonstrated in the early 80s, that stock prices are more volatile than stated by the efficient market theory, and sudden movements are driven by irrational impulses of the market. Therefore, the following financial theories have tried to explain developments in financial markets based on investors` behavior (theories of behavioral economics and behavioral finance).

According to the efficient market hypothesis, it has been considered for a long time that the economy is able to regulate itself, moving towards a steady state, and thus being characterized by stability and full employment. It has been believed that when wages became too high, the economy was contracting and alongside with increasing unemployment salaries began to decline. Moreover, alongside with the reduction of wages, firms began hiring, which led to the revival of the business cycle.

The Keynesian theory has come to contradict this assumption, arguing that employment is determined by the aggregate demand for goods and services, so that when wages fall and employment decreases, demand decreases, which causes a certain reluctance of investors for making investments, which emphasizes increasing unemployment. Under these circumstances, consumers will increase savings at the expense of consumption, which will cause an even steeper decrease of demand. According to Keynes, the economy will reach a balance of underemployment and when aggregate supply becomes greater than aggregate demand, firms will have to reduce prices, which will lead to lower profits.

Keynes has proposed that the way out of recession is the government`s intervention to stimulate aggregate demand and thus increasing employment.

Despite the fact that in the postwar period many governments have implemented Keynesian policies to prevent or stop recessions, they have been criticized by monetarists, who believed that economic instability is exclusively due to fluctuations in the money supply.

Milton Friedman, the most imposing figure of the Monetarist School, has imposed pretty much its influence on economic thought in the 1970s and 1980s, and economic policies have ignored most of Keynes`s ideas, keeping only the one on state intervention in order to stimulate aggregate demand (Roubini and Mihm, 2010). Thus, from the 1930s to early 2010, economic policy was made either based on Keynesian perspectives on macroeconomics, or based on monetary policy as basis for economic development policies, in line with the Friedman`s theories of the 1970s (Bodislav et al., 2015, pp. 107-113).

The authorities` intervention within the economy was also highly criticized by the Austrian School, according to which lax monetary policies, regulations and state intervention in the economy disrupts the smooth operation of the free market. The devotees of this ideology believe that the government should not intervene not even in cases of economic crises, but must leave shaky banks and other companies to collapse so that ultimately only strong economic agents survive. State intervention to rescue bankrupt financial institutions and other companies represents, according to the Austrian School, a socialization of losses, which will increase public debt and deficits. This will compromise the long-term economic growth, and the state could even default, the only solution to this situation being the money printing, but with negative effects on price stability.

The Austrian School also argues that overregulation of markets is the only cause of economic crises, and after a crisis, the tendence of strictly regulating would only worsen the situation. The explanation of this view is that actions such as deposit insurance or government interventions to ensure liquidity help to strengthen banks' risk appetite, although the immediate effect is to provide safety to depositors.

The optimal solution for an economic or financial crisis requires a combination of short-run Keynesian interventionism with long-run Austrians` hypothesis of "creative destruction" (Roubini and Mihm, 2010). Thus, in the context of a financial crisis, lending of last resort is necessary, since its absence would worsen the problems of the financial system and would push the economy into severe recession. On the medium and long run, however, the Austrians seem to be right. Saving bankrupt entities using public money, socializing losses and accumulation of budget deficits can not be sustained for long periods. Therefore, bankrupt companies should be allowed to fail, since otherwise moral hazard leads them to increasingly assume more and more risks.

New paradigms imposed by the crisis

The severity of the crisis has prompted a number of changes both in the economic theory and the economic paradigms considered to be valid. The crisis has generated new paradigms regarding markets` ability of self-regulation, monetary policy, fiscal policy and public finance sustainability, sustainability of the financial system, promoting sustainable economic development and the global dimension of necessary policies to be applied in order to promote stability and growth.

Regulation and supervision

Relatively high incidence of financial crises in the 80's - 90's should have fire alarm signals concerning the validity of efficient markets hypothesis and market fundamentalism. Unfortunately, the emergence of a global crisis was needed to determine awareness of the importance of regulation and supervision of financial markets.

Markets rarely reach the equilibrium postulated by the above hypothesis, as market participants and policymakers may have wrong conceptions and judgements that significantly affect prices, so as to determine the emergence of bubbles, which inevitably lead to crises (Soros, 2009). The assumption that financial crises are some unusual anomalies, impossible to explain and very unlikely has proved false, history showing that they are part of the economic reality.

After the crisis, one of the most criticized aspects was market fundamentalism, "laissez-faire", according to which interventionism should be minimal and market activity should not be affected by excessive regulation or supervision. However, the events have shown that if the state does not regulate and supervise financial markets properly, financial instruments` sophistication combined with excessive liquidity causes excessive exposure to risk, artificially raising the prices of assets and the emergence of speculative bubbles, which burst and cause imbalances in the entire financial system, with severe implications on the real economy (Moldovan, 2012).

It became clear that microprudential regulation and supervision are needed to avoid excessive exposure to risk of financial companies and to enhance their resilience in cases of potential systemic shocks. Microprudential measures are expected to reduce the costs of possible future financial crises, but they must be complemented by macroprudential policies in order to determine the avoidance of pro-cyclical imbalances accumulation.

Reassessment of the monetary policy

Loose monetary policy was another factor that contributed to the financial crisis, as it caused the emergence of a speculative bubble on the US real estate market. Such phenomena have also occurred in European countries. Even in emerging countries such as Romania unrealistic price increases in real estate and stock markets have been recorded. It is clear that the emergence of speculative bubbles would not be possible if not supported by monetary expansion, so that monetary policy plays an important role in this respect.

The crisis has reignited the debate on the role of monetary policy, namely, if it must be designed so as to prevent the emergence of speculative bubbles, or just to help eliminate the negative effects after their burst. Prior to the crisis, the predominant view had been that speculative bubbles could not be identified in real time so that the only solution was to adopt measures to diminish the negative effects of such bubbles after their burst, although it was clear that such an approach encourages moral hazard and excessive exposure to risk (OECD, 2011).

However, the crisis has caused a paradigm shift regarding the role of monetary policy in avoiding bubbles. Thus, monetary policy should avoid cheap credit if it enhances the artificial increase of prices for certain categories of assets (Stark, 2010). Specifically, monetary policy should seek monetary equilibrium that does neither inhibit economic activity, nor potentiate inflation and artificially rising asset prices.

Moreover, central banks should include in their policies considerations regarding financial stability. For example, the European Central Bank has incorporated financial variables in its monetary policy framework, although it is unclear to what extent they influence monetary policy decisions (Svensson, 2010).

Reforming the fiscal system

The seriousness of problems arising in the financial system imposed unprecedented government intervention in order to save the bankrupt financial institutions or to restore financial stability through capital injections, guarantees or asset purchases. All these interventions, combined with diminishing budget revenues and increasing costs due to the recession have put great pressure on government budgets in many countries. The global financial crisis has converted into a sovereign debt crisis in the many economies, especially the ones in the euro area (Greece, Ireland, Spain, Portugal and Italy), affecting their ability to recover. There have even been concerns about a possible collapse of the euro zone, given the gravity of the problems that some European economies have faced.

The turmoil manifested in recent years showed that a public debt lower than 60% of GDP, such as the Maastricht criteria require, is not necessarily sustainable and additional fiscal burden indicators are required in order to establish the fiscal sustainability (Adam, 2014).

Moreover, fiscal consolidation programs in the medium and long run have been necessary, in order to balance state budgets. Fiscal austerity was a pro-cyclical policy which has deepened the recession or hindered economic recovery.

Many European countries are pressed, on the long run, by high spendings for health insurance and pension services, and all these represent additional challenges for fiscal consolidation. Moreover, the debts accumulated during the crisis will also determine additional pressure.

The paradigm shift regarding fiscal policy assumes that it should be characterized by well-designed fiscal rules in order to become sustainable, transparent and counter-cyclical. Therefore, it is aimed at creating fiscal space during periods of economic growth, when the state budget revenues are higher, and its use in times of recession, when budget revenues decrease. Also, government spending must be conditioned and prioritized according to their efficiency, while revenues should be increased by improving collection by reducing tax evasion.

In several European countries, the authorities have created independent fiscal councils to oversee tax compliance and to support the government in the process of achieving long-term sustainability of public finance. An important role of an effective fiscal council is to issue independent views in its attempt to promote transparency of fiscal policy decisions.

Since the debt crisis raised concerns regarding governmental default, assigning a zero risk to sovereign debt, as it was considered under the rules of Basel II and III, became questionable (OECD, 2011).

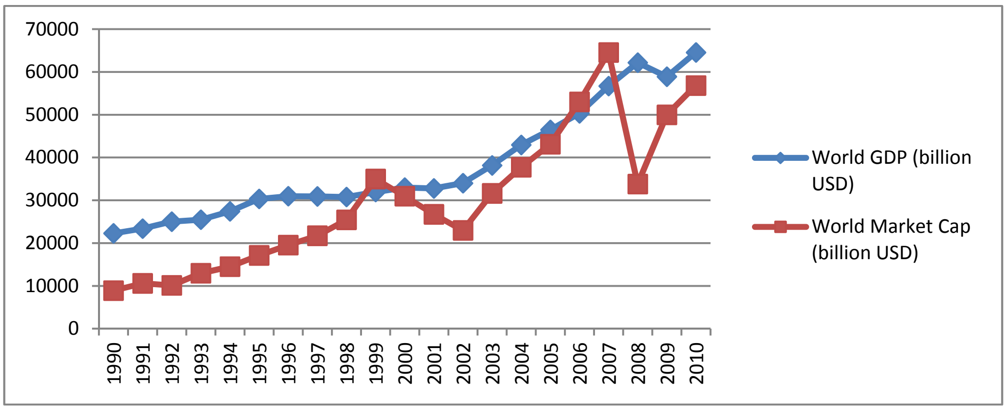
Beyond all this, it is necessary that fiscal policies are combined with appropriate monetary, structural and social policies, so that economic and social costs are reduced in the case of an austerity fiscal policy.

Sustainability

Until the latter part of the XXth century, the financial sector was largely considered as a means of financing the real economy, but then it became more like an end in itself or a framework whose main purpose was to find rapid gains. The shortcomings of this transformation are that nominal economic expansion was relatively artificial and did not bring significant productivity gains, contributing less than expected to increasing the living standards of people and reducing poverty or pollution (Moldovan, 2012).

The figure below shows that the dynamic of global equity markets was much higher than that of global GDP, and in some years the value of equity markets even exceeded the global production of goods and services. It should be noted that equity markets are only part of the size of the global financial system, which also includes bond markets and other financial instruments, such as futures or other sophisticated financial instruments.

Figure 1. *Evolution of stock market capitalization and global GDP*



Source: *World Federation of Exchanges, http://www.world-exchanges.org; World Bank.*

The recession that followed the global financial crisis, coupled with fiscal issues, have led to problems in resource allocation, both in the private and the public sector, which put pressure on sustainable development policy and the sustainability of investment, production and consumption activities (Pisano et al., 2012). The crisis has broken the equilibrium between state and market, and globalization has accelerated the tension between growing and sustainability (Popa and Trașcă, 2014).

Under these circumstances the need for a paradigm shift became clear, in order to determine the integration of sustainability determinants into the organization and functioning of the entire economic system, including the financial system.

Concerns about economic sustainability have been manifested since the second half of the XXth century, but the crisis has also raised concerns regarding the sustainable development of the financial system. Therefore the former activities and tendencies that have led to the artificial development of the financial system should be eliminated and replaced with items that promote sustainable development in the financial field.

The literature does not present an universally accepted definition of financial system`s sustainability, but it is clear that it relates to achieving its fundamental role, namely efficient financing of the real economy, and a healthy, not artificial growth. This requires effective regulation and supervision, so that excessive exposure to risk, overrating of assets, and speculative bubbles will be avoided in the future.

International coordination and cooperation

Given the fact that financial markets and world economies have become highly interconnected and globalized, the problems they face have also become global. Thus, for global problems global policies are needed, and these can be implemented only through international coordination and cooperation between countries.

International authorities should consider integration mechanisms for the national policies so that they can be coordinated so as to promote global economic growth and financial stability. Such mechanisms involve collaboration and communication to set priorities and minimize side effects that may occur due to the application of certain policies at national level.

Conclusions

The severity and complexity of the phenomena that took place in the global economy over recent years have led to a series of changes in the approach, treatment and necessary tools to address these problems.

The efficient markets hypothesis has become widely undermined and the regulation and supervision of financial markets have come to be regarded as very important for achieving and maintaining financial stability.

At the same time, monetary policy has been revised so that it takes into account a number of financial stability indicators, in order to determine the avoidance of speculative bubbles.

Regarding fiscal policy, a counter-cyclical policy is desirable, allowing the creation of fiscal space during economic growth that can be used in times of recession. Also, fiscal consolidation at national level represents a challenge for many countries.

Finally, economic and financial globalization has triggered global issues and their resolution requires international communication, cooperation and collaboration.

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